Mailed 9/23/2002

Decision 02-09-049 September 19, 2002

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF ALIFORNIA

Joint Application of AT&T Communications of California, Inc. (U 5002 C) and WorldCom, Inc. for the Commission to Reexamine the Recurring Costs and Prices of Unbundled Switching in Its First Annual Review of Unbundled Network Element Costs Pursuant to Ordering Paragraph 11 of D.99-11-050.	Application 01-02-024 (Filed February 21, 2001)
Application of AT&T Communications of California, Inc. (U 5002 C) and WorldCom, Inc. for the Commission to Reexamine the Recurring Costs and Prices of Unbundled Loops in Its First Annual Review of Unbundled Network Element Costs Pursuant to Ordering Paragraph 11 of D.99-11-050.	Application 01-02-035 (Filed February 28, 2001)
Application of The Telephone Connection Local Services, LLC (U 5522 C) for the Commission to Reexamine the Recurring Costs and Prices of the DS-3 Entrance Facility Without Equipment in Its Second Annual Review of Unbundled Network Element Costs Pursuant to Ordering Paragraph 11 of D.99-11-050.	Application 02-02-031 (Filed February 28, 2002)

Application of AT&T Communications of California, Inc. (U 5002 C) and WorldCom, Inc. for the Commission to Reexamine the Recurring Costs and Prices of Unbundled Interoffice Transmission Facilities and Signaling Networks and Call-Related Databases in Its Second Annual Review of Unbundled Network Element Costs Pursuant to Ordering Paragraph 11 of D.99-11-050.	Application 02-02-032 (Filed February 28, 2002)
Application of Pacific Bell Telephone Company (U 1001 C) for the Commission to Reexamine the Costs and Prices of the Expanded Interconnection Service Cross-Connect Network Element in the Second Annual Review of Unbundled Network Element Costs Pursuant to Ordering Paragraph 11 of D.99-11-050.	Application 02-02-034 (Filed February 28, 2002)
Application of XO California, Inc. (U 5553 C) for the Commission to Reexamine the Recurring Costs of DS1 and DS3 Unbundled Network Element Loops in Its Second Annual Review of Unbundled Network Element Costs Pursuant to Ordering Paragraph 11 of D.99-11-050.	Application 02-03-002 (Filed March 1, 2002)

OPINION ON REMAND ADDRESSING SHARED AND COMMON COST MARKUP ESTABLISHED IN DECISION 99-11-050 AND UNBUNDLED NETWORK ELEMENT RECURRING PRICES

I. Summary

This decision addresses a remand ordered by the U.S. District Court for the Northern District of California. (*AT&T Communications of California Inc. et al., v. Pacific Bell Telephone Company, et al.*, Order on Cross Motions for Summary Judgment, No. C01-02517 (CW)(N.D. Cal. August 6, 2002)("Remand Order"). In response to the Remand Order, this decision modifies the shared and common cost markup percentage, which is a component of the price of unbundled network elements (UNEs) that Pacific Bell Telephone Company (Pacific) charges competing local telephone carriers for use of its network. The shared and common cost markup that was originally adopted in Decision (D.) 99-11-050 is increased from 19% to 21%. This increase results from removal of $537.8 million in non-recurring UNE costs that appear to have been inadvertently double-counted in D.99-11-050.

This decision also orders modification to Pacific's monthly UNE recurring charges. The Commission concludes that the total direct UNE cost figure that the Court remanded for review was also used to set Pacific's monthly recurring charges. Therefore, the double-counting must be remedied in those charges as well. The decision calculates the amount of overstatement in recurring costs and directs Pacific to remove 13% from the expense portion of its UNE recurring costs. The Commission will review and adopt these changes after further filings by the parties in response to today's order.

The changes ordered by this decision to the markup and recurring costs shall be made on a prospective basis from the effective date of this order. The implementation of the 2% increase in the markup is stayed pending resolution of the amount of adjustment needed to monthly recurring charges so that both of these changes can be implemented simultaneously. Once the adjustment to

recurring costs is identified, all UNE rate changes ordered today will be implemented with today's effective date. Pacific is directed to track the UNEs purchased by other carriers that are impacted by these UNE rate changes so that once the net rate change is identified, it can be made effective today.

II. Background

In D.99-11-050,[1] the Commission adopted prices for the unbundled network elements, or UNEs, that Pacific sells to competitors who use portions of its network. One aspect of the prices adopted in that order involved a percentage markup over the forward-looking cost of UNEs to recover Pacific's "shared and common costs."[2] The Commission adopted a markup percentage of 19% based on a calculation of Pacific's shared and common costs divided by the total direct costs of UNEs and total non-recurring costs of UNEs.[3] This means

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[1] D.99-11-050 was issued in the Commission's Rulemaking and Investigation to Govern Open Access to Bottleneck Services and Establish a Framework for Network Architecture and Development of Dominant Carrier Networks (Rulemaking 93-04-003 / Investigation 93-04-002) ("OANAD proceeding").

[2] Shared and common costs are defined in Appendix C of D.95-12-016. According to page 6 of Appendix C, shared costs are defined as "costs that are attributable to a group of outputs but not specific to any one within the group, which are avoidable only if all outputs within the group are not provided." Common costs are defined as "costs that are common to all outputs offered by the firm." The Federal Communications Commission (FCC) has defined "forward-looking common costs" as "economic costs efficiently incurred in providing a group of elements or services (which may include all elements or services provided by the incumbent [local exchange carrier]) that cannot be attributed directly to individual elements or services." (47 C.F.R. 51.505(c)(1).)

[3] Specifically, the Commission found that to calculate the markup percentage, the $996 million total of shared and common costs for all UNEs should be divided by the sum of (a) the total direct TELRIC costs for all UNEs of $4.814 billion (as approved in D.98-02-106 and related compliance filings), plus (b) total non-recurring costs of $375 million (adopted in D.98-12-079). (D.99-11-050, *mimeo.*, p. 72, and p. 257.) TELRIC refers to the "total element long run incremental cost" methodology.

that for each UNE that Pacific sells to competitors, the cost of that UNE is increased by 19% to establish a UNE price.

In D.99-11-050, the Commission noted the need to review the status of the UNE prices it was setting. Therefore, the order established a process for an annual reexamination of the costs of no more than two UNEs, but limited the scope of the review to bar requests to reconsider the 19% markup percentage.[4] The Commission's first annual reexamination proceeding commenced in February 2001, when AT&T Communications of California, Inc. and WorldCom, Inc. (hereinafter referred to as "Joint Applicants") filed applications nominating specific UNEs for review.[5]

In the fall of 2001, AT&T Communications of California, Inc., MCI Worldcom Network Services, Inc. and MCImetro Access Transmission Services LLC (jointly "Plaintiffs") filed a suit in U.S. District Court seeking to overturn aspects of D.99-11-050 related to the shared and common cost markup. Plaintiffs argued that the Commission improperly determined Pacific's firm-wide shared and common costs and unreasonably allocated these costs only to UNEs. (Remand Order, p. 23.)

In a cross-motion, Pacific argued, among other things, that the Commission had double-counted non-recurring costs in its calculation of the shared and common cost markup. Specifically, Pacific claimed that the

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[4] The Commission based this prohibition on the logic that reexamination of the markup would require reconsideration of all of Pacific's TELRIC costs and would be a "daunting task." (D.99-11-050, p. 169, n. 155, and p. 272.)

[5] The original applications (A.01-02-024 and A.01-02-035) were later consolidated with four applications filed in 2002. These six applications comprise the current "2001 / 2002 UNE Reexamination Proceeding."

denominator used in the markup calculation was unreasonably inflated because the Commission added non-recurring costs of $375 million, as adopted in D.98-12-079, despite Pacific's assertions that non-recurring costs were already included in Pacific's original estimate of direct UNE costs. (*Id.*, p. 18.) Pacific explained that its original cost study claimed a total of $4.83 billion in direct UNE costs, which included both recurring costs and a $583 million estimate of non-recurring costs. In D.98-02-106, the Commission adopted a total direct UNE cost amount of $4.814 billion. According to Pacific, it is mathematically impossible to subtract $583 million from $4.83 billion and arrive at a result of $4.814 billion, even with the other adjustments ordered by the Commission to Pacific's original cost estimate.[6] Because none of the adjustments ordered by the Commission dealt with removal of non-recurring costs, Pacific reasons that the Commission failed to remove the $583 million in non-recurring costs despite the Commission's assertions that the $4.814 billion adopted in D.98-02-106 did not include non-recurring costs. (*Id.*) To correct the situation, Pacific suggests the

[6] As Pacific explained to the District Court, compliance filings provided by Pacific to the Commission between the January 1997 Cost Study and D.99-11-050 identify those few instances in which Pacific adjusted the total direct cost of UNEs used in the denominator of the markup. Pacific claims that none of these adjustments required Pacific to remove, or even addressed, non-recurring costs. The required adjustments involved reducing loop-related repair expenses, adjusting Pacific's fill factor, correcting errors in the modeling of switching investment and switch vendor prices, revising the loop study to include unintentionally omitted wire centers, and adjusting Pacific's product management expenses. (*See* Pacific Comments, 8/28/02, p. 5, n. 17.) Pacific also argued to the District Court that if the Commission had excluded non-recurring costs from Pacific's original estimate, it would have begun with $4.2927 billion and would have had to order more than $521 million in increases to Pacific's total cost figure. Yet the adjustments the Commission ordered involved a net decrease of $17 million. (*See* Pacific Reply Comments, 9/4/02, p. 6, n. 13).

Commission should have substituted the $375 million non-recurring cost amount adopted in D.98-12-079 for the earlier $583 million estimate.

On August 6, 2002, the U.S. District Court issued its Remand Order. The court denied all of Plaintiffs' claims and denied all but one of Pacific's claims. The court agreed with Pacific that the Commission had double-counted non-recurring costs when it calculated Pacific's total direct costs of UNEs. Specifically, the court concluded that the Commission had failed to remove Pacific's original $583 million estimate of non-recurring costs when it added $375 million to Pacific's cost of providing UNEs. In the Remand Order, the Court essentially agreed with the reasoning offered by Pacific and found that the Commission's arguments that it had not engaged in double-counting failed based on simple arithmetic. (*Id.*, p. 37) As part of its analysis, the Court noted that the Commission adopted the $4.814 billion amount from Pacific's revised cost studies after making adjustments that did not include removing the non-recurring cost estimate. (*Id.*, pps. 37-38.) In effect, the court found that the denominator of the markup calculation was inflated, and the markup percentage thereby lowered, due to this error. The order states, "The [Commission's] determination of Pacific's direct cost of providing UNEs (the denominator of the common cost markup), and any decision which relies on this determination, must be vacated and remanded, so that the double-counting can be remedied." (*Id.*, p. 38.)

On August 22, 2002, the Commission issued D.02-08-073 in the UNE Reexamination Proceeding, removing the restriction contained in D.99-11-050 that precluded review of the 19% shared and common cost markup in annual cost reexamination proceedings. The decision directed the Commission to

review the shared and common cost markup within the scope of this 2001 / 2002 UNE Reexamination Proceeding to comply with the Remand Order.

On August 15, 2002, the assigned ALJ in the UNE Reexamination Proceeding issued a ruling in anticipation of the issuance of D.02-08-073 that initiated the comment process ultimately directed by that order.[7] Specifically, the ruling requested comments on the correct methodology to adjust the denominator of the markup calculation given the Court's finding of double-counting. Further, the ruling requested comments on what decisions the Commission needed to vacate and / or adjust in order to comply with Court's Remand Order. Finally, the ruling also asked whether any adjustments to the markup calculation should be made on a retroactive basis, or only on a prospective basis.

In response to the August 15th ruling, Allegiance Telecom of California, Inc. (Allegiance), Joint Applicants, Pacific, and XO California, Inc. (XO) filed comments. Joint Applicants, Pacific, and XO filed reply comments.

III. Removal of Double-Counting in the Shared and Common Cost Markup

Pacific's Position

Pacific maintains that the Commission need only make a simple arithmetical correction to the markup calculation to comply with the Remand Order. Specifically, Pacific states that given the Court's finding that the denominator of the markup calculation double-counted non-recurring costs, the Commission should subtract from the denominator the estimate of non-recurring

[7] *See*, "ALJ's Ruling Requesting Comments on Remand of the Shared and Common Cost Markup," August 15, 2002.

costs that Pacific originally included in its estimate of total direct UNE costs. Since the Commission separately found in D.98-12-079 that non-recurring costs

were $375 million, the original estimate of non-recurring costs that was included in the total direct UNE costs should be removed. Pacific explains that its original estimate for non-recurring costs was $583 million, but this figure was later revised downward to $537.8 million based on a "labor rate adjustment" of $45.5 million.[8] Therefore, Pacific maintains that the Commission should now subtract $537.8 million from the denominator.

To support this approach, Pacific explains that in the Remand Order, the Court agreed with Pacific and found that the total direct UNE cost figure in the denominator of the markup calculation (i.e. $4.814 billion) was based directly on revised cost studies provided by Pacific after making Commission ordered adjustments that did not include removing the non-recurring cost estimate. (Remand Order, pps. 37-38.)

According to Pacific, once the non-recurring cost estimate of $537.8 million is appropriately subtracted, the denominator of the markup calculation would be reduced from the $5.189 billion[9] set forth in D.99-11-050 to $4.65 billion. To recalculate the markup percentage, total shared and common costs of $996 million would be divided by $4.65 billion, yielding a markup percentage of 21.4%, which rounds down to 21%.

Pacific states that once this correction to the shared and common cost markup is made, the Commission should order revisions to both the permanent rates set in D.99-11-050 and the interim rates adopted in D.02-05-042 so that the

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[8] *See* Pacific Bell Comments, 8/28/02, Addendum, Tab D-5, pg. 2, line 27 and p. 7, lines 9-11.

[9] $4.814 billion + $375 million = $5.189 billion. (D.99-11-050, p. 72).

recalculated markup can be corrected in UNE prices in all interconnection agreements between Pacific and other carriers.

Joint Applicants' and Other Competitive Carriers' Positions

Contrary to Pacific's comments, Joint Applicants do not agree that any double counting has occurred and they notice their intent to appeal the Remand Order. They fundamentally disagree that the Commission can correct any double-counting error in the markup calculation through a simple mechanical adjustment to the denominator of the markup. Rather, Joint Applicants contend that a complete reexamination of the record from the OANAD proceeding is required before any adjustments can be made.

Joint Applicants maintain that Pacific's current position regarding the double-counting of non-recurring costs, and its position before the U.S. District Court, is directly contrary to statements of its cost expert, Richard Scholl, during the OANAD proceeding. According to Joint Applicants, Scholl testified under oath at a deposition that there were no non-recurring costs included in the recurring cost study used to calculate total direct UNE costs. (See Joint Applicants Comments, 8/28/02, Exh. D. "Deposition of Richard Scholl, 3/22/96" and Joint Applicants Reply Comments, 9/4/02, Exh. A.) Joint Applicants claim this testimony contradicts Pacific's current claims that the total direct UNE cost figure of $4.814 billion included $537.8 million in non-recurring costs.

Because of this contradiction, Joint Applicants argue that the Commission must now decide between three courses of action. First, the Commission could rely on the sworn deposition testimony of Pacific's own witness Scholl and thereby ignore Pacific's current claims regarding double-counting. This would result in no changes to the markup calculation. Second, the Commission could ignore Scholl's testimony and remove double-counting from the markup and

from Pacific's UNE recurring costs.[10] Third, the Commission could avoid deciding between these two contradictory positions entirely by instead removing any double-counting through an update to the markup using current cost data.

In support of this third option, Joint Applicants maintain that the only proper method to correct any double-counting is to set a new shared and common cost markup and new recurring costs, and prices, based on current cost data. They contend that Pacific's shared and common costs have significantly decreased since studied in 1994 because of SBC's 1997 merger with Pacific Telesis and its 1999 merger with Ameritech. Joint Applicants describe how SBC justified these mergers with forecasts that they would result in substantial overhead cost savings. Specifically, SBC claimed $1 billion in expense savings from the merger with Pacific Telesis and $1.7 billion in cost savings from the Ameritech merger. (Joint Applicants Comments, 8/28/02, pps. 17-18.) Moreover, Joint Applicants state that Pacific's own ARMIS[11] data for corporate overhead expenses show a decrease of 12% from 1994 to 2000. (*Id.*)

Joint Applicants contend that calculating shared and common, or overhead, costs is the least complex part of a recurring cost study since overhead costs are simply high level company expenses projected on a forward-looking basis. Joint Applicants propose a formula for this purpose that uses publicly

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[10] This proposal to adjust recurring UNE prices is discussed in Section IV.

[11] ARMIS (Automated Reporting Management Information System) is a data collection and information system maintained by the FCC. It contains data that incumbent local exchange carriers such as Pacific provide to the FCC pursuant to FCC reporting requirements.

available ARMIS data for a simple calculation that provides a ratio of overhead costs to total costs.[12]

XO and Allegiance express support for the Joint Applicants' position that the Commission should comprehensively review the shared and common cost markup calculation based on current data rather than simply making mathematical corrections to the former calculation.

Pacific opposes Joint Applicants' proposal that the Commission abandon its methodology for calculating the shared and common cost markup for a new method using ARMIS data. Pacific notes that aside from the mathematical error regarding double counting, the current methodology was upheld by the Court as fully consistent with the 1996 Telecommunications Act and FCC rules. Pacific states that Joint Applicants' proposal violates the FCC's TELRIC standards because it is based on an average of data for all Bell companies, it relies on historical rather than forward-looking data, and it uses revenues rather than costs as required by Section 252(d)(2) of the 1996 Telecommunications Act. (47 U.S.C § 252(d)(2)) Fundamentally, Pacific characterizes Joint Applicants as attempting to throw out the entire OANAD record and start over. Pacific states that Joint Applicants provide no basis for this "extraordinary suggestion" to cast aside the entire OANAD proceeding and recalculate everything.

Further, Pacific argues it is too late to raise arguments about mergers that took place prior to the adoption of the markup in D.99-11-050. According to Pacific, the current markup incorporates a forward-looking analysis that

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[12] The proposed formula is:

$$\frac{\text{Total Regulated Corporate Operations Expense}}{(\text{Total Regulated Operating Revenues} - \text{Total Regulated Corporate Operations Expense})}$$

assumed Pacific would realize substantial future overhead savings. Pacific contends there is no reasoning to support the suggestion that the mergers have resulted in more savings than was built into the common cost figures used in D.99-11-050. (Pacific Reply Comments, 9/4/02, p. 11.)

With regard to the deposition testimony of its witness Scholl, Pacific implies that Joint Applicants are only attempting to "muddy the waters" with information outside the record of the original OANAD proceeding that is more properly the subject of an appeal of the Remand Order. Pacific states that Scholl's deposition was never introduced into the record of OANAD and the cost study he refers to in his testimony was superseded by a subsequent version that specifically delineated recurring and non-recurring costs.

Discussion

We regret that we find ourselves in the position of having to revisit the shared and common cost markup originally calculated in D.99-11-050. The parties and the Commission expended enormous effort to perform and analyze the cost studies that led to the 19% markup and the UNE prices ultimately adopted in that order. We do not wish to devalue the extraordinary efforts of so many people during the course of the OANAD proceeding by opening up old wounds, particularly to put a hasty patch over them. Indeed, we are hesitant to make these changes after the passage of so much time because there is a dangerous potential that, in presenting mere excerpts from spreadsheets, testimony, and all of the other components of the prior OANAD record, parties can now take bits of information, potentially out of context, to support vastly different outcomes years later. Nevertheless, the Remand Order, and its finding that the Commission could not adequately explain whether or how non-

recurring costs were removed from Pacific's total direct UNE cost estimates, force us to review the markup percentage and its origins.

Despite our hesitation at undertaking this exercise on an expedited basis, the principal question before us in responding to the Remand Order is whether we should make a simple and quick arithmetical correction to remove the double-counting found by the Court, or whether we should take a fresh look at the markup percentage based on current data. The first option, while quick and relatively simple, is complicated by the testimony of Pacific's own witness that there were no non-recurring costs included in calculations that underlie the adopted total direct UNE cost figure of $4.814 billion. The latter option, namely calculating an entirely new shared and common cost markup with current ARMIS data, holds some appeal because of the potential that Pacific's overhead costs have changed since cost studies were last performed based on 1994 data. On the other hand, there is no question that this endeavor would require more time and involve more resources than the mathematical correction proposed by Pacific. If we were to entertain entirely new markup methodologies, we need time to iron out the details.

Although both options are problematic, we refuse to see these two options as mutually exclusive. In view of the Remand Order, we will opt to make an immediate correction to the markup calculation made in D.99-11-050 to remove the double-counting found by the Court. At the same time, we realize that a complete review of Pacific's shared and common costs would be wise. Unfortunately, we cannot commit the resources at this time to such a resource-intensive endeavor.

Therefore, to comply with Remand Order, we find that we should promptly correct the denominator of the markup percentage that the Court

found had double-counted non-recurring costs. Pacific has reasonably shown that the number we adopted for total direct UNE costs of $4.814 billion was based on its cost studies submitted in 1997 and revised by further filings. Pacific's original estimate included $583 million in non-recurring costs, which was later adjusted to $537.8 million based on a the "labor rate adjustment." We find that none of the revisions to the 1997 filing removed either this $583 million or $537.8 million in non-recurring costs that were included in the original total direct UNE cost estimate. Therefore, to remove double counting of non-recurring costs in the denominator of the markup, we should subtract the original $537.8 million estimate of non-recurring costs that is embedded in the $4.814 billion total direct UNE cost figure because it was replaced with the new amount of $375 million that was adopted in D.98-12-079.

When we perform this subtraction, the $4.814 billion figure is reduced to $4.65 billion,[13] which becomes the new denominator in our calculation of the shared and common cost markup. To complete the markup calculation, we substitute the new figure of $4.65 billion into the formula we used in D.99-11-050. Specifically, we start with the $996 million in total shared and common costs for all UNEs,[14] and divide by $4.65 billion in total direct UNE costs and non-recurring costs. This computation results in a markup of 21.4%, which consistent with prior Commission practice, rounds down to 21%.

We make this correction to the markup calculation despite Joint Applicants' numerous arguments that there was no double-counting in D.99-11-050. Principally, Joint Applicants rely on the conflicting deposition

[13] $4.814 billion - $537.8 million + $375 million = $4.651 billion

testimony provided in 1996 by Pacific's witness Scholl to argue against modifications to the markup. Pacific charges, and Joint Applicants do not deny, that the deposition was never introduced into the original OANAD proceeding. Despite this, Joint Applicants ask that it now be considered. We agree with Joint Applicants that Scholl's testimony contradicts Pacific's current position regarding double-counting of non-recurring costs because he states there are no non-recurring costs in the recurring cost study used to develop the $4.814 billion in total direct UNE costs.[15] With all due respect to Mr. Scholl, his testimony is directly contradicted by the figures contained in the cost filings filed in 1997, which includes line items for non-recurring costs. We should not consider the Scholl testimony because it was not on the record of the original OANAD proceeding. Even if we did consider it, we would give greater weight to the actual cost filing that occurred after the date of the Scholl deposition than to deposition testimony taken a year in advance of that filing. We note that the

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[14] D.99-11-050, p. 72.

[15] Scholl's testimony directly relates to output pages from Pacific's recurring cost study. These output pages are labeled as "PBON 001684" through "PBON 001746." (*See* Joint Applicants Comments, 8/28/02, Exh. C and Exh. D, p. 776, lines 19-20). Pacific's 1997 Cost Filing indicates that the "Sum of Operating Expense from PBON 001684 through PBON 001746" is the source for the $4.139 billion in "1994 Total Regulated Operating Expenses" (*Id.*, Exh. A, Tab D-5, p. 8, line 17). This $4.139 billion factors into Pacific's estimate of $4.83 billion in total direct UNE costs. Indeed, Pacific's own filings before the District Court identify the same 1994 Total Regulated Operating Expense Figure and stated that the figure "includes both recurring and non-recurring costs." (*See* Addendum to Pacific Bell Comments, 8/28/02, "Opposition to Plaintiff's Motion for Summary Judgment and Memorandum in Support of Cross-Motion for Summary Judgment," p. 26.) Thus, while Scholl says the output pages ultimately used to calculate the total direct UNE costs do not include non-recurring costs, Pacific now indicates non-recurring costs are included here.

Court relied on the actual cost filings when deciding the double-counting issue in the Remand Order and Scholl's testimony was never raised.

Further, Joint Applicants imply that the Commission must have converted some of what Pacific labeled non-recurring costs into recurring costs. Even if this were the case, there is no support in D.99-11-050 or elsewhere for this claim. Joint Applicants' assertions that Pacific did not prove there was double counting are more appropriate for an appeal of the District Court's Remand Order. If there were support for this contention, there would likely have been no Remand Order in the first place. The fact is that the Commission used Pacific's estimated total direct UNE costs as a starting point for the numbers used in the markup calculation. Pacific has sufficiently shown how the figure of $4.814 billion used in the markup calculation can be traced directly back to Pacific's original total direct UNE cost estimate of $4.83 billion. Pacific's calculations and its support for all of the figures used in these calculations are summarized in Appendix A.

As we stated above, we will make the correction described above to the denominator and increase the shared and common cost markup from 19% to 21%. This change shall be effective with this order. We will also endeavor to review Pacific's shared and common costs based on current information at some future date. We will not commit resources at this time to this effort, but we will consider it as we set our telecommunications priorities for the future. Although Joint Applicants would prefer that we take a fresh look at shared and common costs immediately, using their new methodology, we believe that consideration of their new methodology would be a complicated task and divert significant time and resources from other current priorities. We opt to make arithmetical adjustments to the method that we used in D.99-11-050 rather than undertake a fresh look at the markup right now. It is our view that the actions we take today,

namely a quick correction coupled with a future review of the markup, are adequate and fully comply with the Remand Order. We will, however, not foreclose Joint Applicants from resubmitting their proposal when we review the markup at some future date.

IV. Removal of Non-Recurring Charges from Recurring Costs

Joint Applicants' Position

According to Joint Applicants, if the Commission finds that it must remove non-recurring costs from Pacific's total direct cost of UNEs, these same non-recurring costs were inappropriately included in Pacific's recurring costs as well. Joint Applicants claim that the source of the non-recurring costs is the 1994 Total Regulated Operating Expenses of $4.139 billion set forth in Pacific's 1997 Cost Study.[16] Joint Applicants' explain that the 1994 Total Regulated Operating Expenses Figure contained in the 1997 cost filing is the only expense figure large enough to potentially include $583 million in non-recurring costs. They maintain that this $4.139 billion amount is precisely the same expense amount that figures into the expense portion of Pacific's recurring costs. Pacific's 1997 cost filing shows that the $4.139 billion expense figure is a building block of the $4.814 billion in total direct UNE costs adopted in D.99-11-050. (*Id.*) Thus, if the Commission finds that there are non-recurring costs included in the $4.139 billion 1994 Total Regulated Operating Expenses, then it must conclude that these same non-recurring costs made their way into recurring charges.

[16] The source of this $4.139 billion is described on p. 8 of Tab D-5 as "Sum of Operating Expenses from PBON 001712 through PBON 001746," which are pages of Pacific's 1997 Cost Study. (*See* Joint Applicants Comments, 8/28/02, Exh. A, Tab D-5, p. 8, line 17.)

For recurring costs, Joint Applicants suggest that if the Commission cannot commit the resources to reviewing all recurring costs with new data, it could implement a simple fix to the current recurring costs. This simple fix would

involve calculating the average overstatement of recurring costs based on the $583 million in non-recurring costs originally included in Pacific's total direct UNE costs.[17]

Pacific's Response

Pacific disagrees with Joint Applicants' suggestion that UNE recurring charges also require adjustment based on the Remand Order. Pacific maintains that the recurring costs set in D.98-02-106 are final, were affirmed on rehearing, and the Remand Order has no bearing on them. Accordingly, Pacific argues that Joint Applicants may not circumvent the proper appeal procedure and challenge the recurring costs in this manner. In addition, Pacific rebuts Joint Applicants' claims regarding recurring costs by alluding to a subsequent cost study that specifically delineated recurring and non-recurring costs. (Pacific Reply Comments, 9/4/02, p. 9, n. 19) Pacific alleges that nonrecurring costs were excluded from the direct costs of individual UNEs that formed the basis of D.98-02-106.

Discussion

We find Joint Applicants' assertions quite compelling. If non-recurring costs were included in Pacific's estimate of total direct UNE costs, these same non-recurring costs had to have been included in all of Pacific's recurring costs that were established based on this same total direct UNE cost estimate.

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[17] Joint Applicants suggest calculating this overstatement by taking $583 million in non-recurring costs allegedly included in 1994 Total Regulated Operating Expenses and dividing this by 1994 Total Regulated Operating Expenses. (The figure for 1994 Total Regulated Operating Expenses can be found in Joint Applicants' Comments, 8/28/02, Exhibit A, Tab D-5, p. 8, line 17.)

Before turning to the substance of our reasoning, we disagree with Pacific that Joint Applicants are circumventing the proper appeal procedures and it is too late for Joint Applicants to challenge recurring UNE costs and request adjustments. The Remand Order specifically vacates and remands the Commission's "determination of Pacific's direct cost of providing UNEs (the denominator of the common cost markup), *and any decision which relies on this determination*…" (Remand Order, p. 38.)(emphasis added) The $4.814 billion direct cost of providing UNEs that is referred to by the Court is identical to the $4.814 billion figure used in D.98-02-106 and related compliance filings to set recurring costs. (D.99-11-050, p. 72, n. 72) By its own wording, the Remand Order directs that any decision relying on the direct cost of providing UNEs must be remedied. The Commission cannot look at a correction to the $4.814 billion direct cost of providing UNEs in isolation and ignore the direct and substantial impact that a correction to that figure might have on other decisions that were based on that same calculation of $4.814 billion. Therefore, the Commission must address the direct cost of providing UNEs used in D.98-02-106. Joint Applicants' current claim, which arises from the Remand Order's finding of double recovery of non-recurring costs in the total direct UNE cost figure, is not inappropriate.

More substantively, Pacific states that there was a "subsequent cost study" that formed the basis of the recurring costs set in D.98-02-106 and, therefore, the Commission should ignore Joint Applicants' assertions about the need to revise recurring charges. Pacific provides no citations or references to support its claims about a "subsequent cost study" and we cannot rely on these unsupported assertions. As we explain below, we find that the computations underlying Pacific's 1997 cost study that lead us to find double counting of

non-recurring costs in the markup are exactly the same calculations that were used to develop the $4.814 billion in total direct UNE costs approved in D.98-02-106 and related compliance filings, and later used to set recurring prices in D.99-11-050.[18]

Overall, we find that since we have already concluded that the $4.814 direct cost of providing UNEs included $537.8 million in non-recurring costs, these non-recurring costs were also incorporated into the recurring costs adopted in D.98-02-106 and related compliance filings. Joint Applicants have shown that the $4.139 billion estimate of 1994 Total Regulated Operating Expenses is a component of Pacific's 1997 total direct UNE cost estimate of $4.83 billion. Joint Applicants' have also shown, and Pacific's court filings support, that the 1994 Total Regulated Operating Expenses Figure contained in the 1997 cost filing is the only expense figure large enough to potentially include over $500 million in non-recurring costs.[19] The $4.83 billion originally estimated by Pacific was revised downward to $4.814 billion and used to calculate UNE costs in D.98-02-106. (D.99-11-050, p. 72). Pacific has already shown to the District Court and now to this Commission that the $4.83 billion included non-recurring costs and

[18] For a summary of these calculations, see Appendix A.

[19] Pacific does not dispute this. As we have indicated above in footnote 15, Pacific's own statements to the District Court referred to the same 1994 Total Regulated Operating Expense Figure and stated that the figure "includes both recurring and non-recurring costs." (See Addendum to Pacific Bell Comments, 8/28/02, "Opposition to Plaintiff's Motion for Summary Judgment and Memorandum in Support of Cross-Motion for Summary Judgment", p. 26.) As Joint Applicants note, all the other figures contained in that cost filing which figure into the calculation of Total direct UNE costs are either investment figures that do not involve non-recurring costs or are too small to include an amount of that magnitude.

none of the downward revisions to that figure involved removal of non-recurring costs. (*See* Pacific Comments, 8/28/02, p. 5, n. 17, and Pacific's Reply Comments, 9/4/02, p. 6, n. 13.) Thus, recurring prices established using that same $4.139 billion in 1994 Total Regulated Operating Expenses also include the same $537.8 million original estimate of non-recurring costs.[20] In other words, Pacific is double-recovering non-recurring costs because $537.8 million in non-recurring costs is included in recurring prices, while at the same time, Pacific is charging separate non-recurring prices based on the finding of $375 million in non-recurring costs in D.98-12-079. Based on the same logic that non-recurring costs must be removed from the $4.814 billion total direct cost of UNEs, we should remove any non-recurring costs in the recurring costs adopted based on the $4.814 billion.

To remedy this double recovery, Joint Applicants have proposed that the Commission review all of Pacific's recurring UNE costs, or in the alternative, implement a simplified fix to the current recurring costs. We opt for the simplified fix for the same reasons that we are making the simplified fix to the markup calculation. We do not believe that a complete review of all UNE recurring prices is a wise use of our resources at this time.

The simple fix proposed by Joint Applicants involves calculating the average overstatement in recurring costs caused by the inclusion of $537.8 million in the $4.139 in 1994 Total Regulated Operating Expenses. In other words, we should reduce the expense component of UNE recurring costs by the percent that expenses were overstated. When we divide $537.8 million by $4.139

[20] We will assume the same labor rate adjustment that lowered the $583 million to $537.8 million.

billion, this yields 12.9% which rounds to 13%. Thus, operating expenses were overstated by 13% when recurring costs were adopted in D.98-02-106. To correct

this 13% overstatement, we shall direct Pacific to submit its calculation of the reduction to the expense portion of the recurring costs of each of its UNEs. Pacific should submit its calculations, fully supported with workpapers and appropriate documentation, as a filing in this docket within 30 days of this order.

V. Retroactive Adjustment

Parties' Positions

Joint Applicants oppose the concept of any retroactive adjustment to the shared and common cost markup, stating that this would entail not only abysmal public policy leading to "crippling uncertainty" in competitive telecommunications markets, but also retroactive ratemaking in which the Commission is not authorized to engage.[21] Further, Joint Applicants argue that a retroactive adjustment to rates in light of the Remand Order would be inequitable given that other UNE rate changes have not been made retroactively, even where the Commission's has found that UNE rates were inflated.

Likewise, XO urges the Commission not to apply any changes to the markup calculation retroactively because a retroactive adjustment would have a devastating impact on the development of local exchange competition in California. Similar to Joint Applicants, XO considers the idea of a retroactive correction poor public policy because it would jeopardize future reliance on Commission orders. Allegiance echoes the comments of Joint Applicants and XO that any adjustment should apply prospectively only.

Pacific suggests that any UNE price adjustments based on the Remand Order should be implemented prospectively for now, and that the question of

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[21] Joint Applicants' Comments, 8 / 28 / 02, pps. 24-25, citing *Pacific Telephone & Telegraph Co. v. Pub. Util. Comm. of Calif.*, 62 Cal.2d 634, 650 (1965).

whether UNE prices should be revised retroactively can be addressed later. Pacific disagrees that a retroactive adjustment to UNE rates would constitute "retroactive ratemaking." Rather, Pacific maintains that the Commission, pursuant to federal law, has the authority to "undo what is wrongfully done by virtue of its order," even where its statutory authority to fix rates is "prospective only." (*United Gas Improvement Co. v. Callery Properties, Inc.*, 382 U.S. 223, 229-30 (1965). According to Pacific, the Commission has the authority to implement a retroactive adjustment when its rates are judicially reversed. (*See Natural Gas Clearinghouse v. FERC*, 965 F.2d 1066, 1073-4 (D.C. Cir. 1992).

Discussion

We agree with Pacific that the Commission has the authority to order retroactive rate adjustments in responding to the Court's Remand Order. In *United Gas*, the Supreme Court upheld FERC-ordered[22] refunds that FERC approved on remand of a rate order that had been overturned by a reviewing court. The Supreme Court made clear that FERC had the authority to order such refunds without violating the rule against retroactive ratemaking, and it also found that FERC's exercise of such authority was a matter of discretion.

Several years later, in *Exxon Company, USA v. FERC*, 182 F.3d 30 (D.C. Cir. 1999), the D.C. Circuit stated that while "FERC does have a measure of discretion in determining when and if a rate should apply retroactively, … such discretion is not without its limits." (*Id.* at 49.) The court explained that:

[22] The Federal Energy Regulatory Commission (FERC) was known as the Federal Power Commission at the time of this case.

> "[t]here is … a strong equitable presumption in favor of retroactivity that would make the parties whole. As we have stated, "when the Commission commits legal error, the proper remedy is one that puts the parties in the

> position they would have been in had the error not been made. *CPUC*, 988 F.2d at 168."

At the same time, the *Exxon* court made clear that the agency could consider equitable factors in determining whether to apply a rate retroactively. "This is not to say that FERC must do so in every case if the other considerations properly within its ambit counsel otherwise." (*Id.*)

The D.C. Circuit reiterated the principles in the above cases most recently in *Verizon Telephone Cos. v. FCC*, 269 F.3d 1098 (D.C. Cir. 2001). Among other things, the court reiterated that an agency's decision to make retroactive adjustments in the wake of a court order was a matter of discretion. "We have previously held that administrative agencies have greater discretion to impose their rulings retroactively when they do so in response to judicial review, that is, when the purpose of retroactive application is to rectify legal mistakes identified by a federal court." (*Id.*, at 1111.)

Given the foregoing, we will exercise our discretion in this case to not retroactively adjust rates in response to the Remand Order. Although we are aware of the strong equitable presumption in favor of retroactivity that would make the parties whole, we find that there are equitable considerations that militate against making retroactive adjustments to UNE rates at this time. First, we note the recent spate of bankruptcies in the telecommunications sector that have placed many of the competitive carriers that would be impacted by a retroactive UNE rate adjustment into bankruptcy proceedings. It is reasonable to conclude that any carriers currently under bankruptcy protection would have difficulty making any back payments to Pacific for monies owed retroactively to 1999 when the 19% markup was originally adopted.

Second, we agree with those who have commented that it would be bad public policy to inject further uncertainty into the competitive telecommunications sector by leaving the question of retroactive rate adjustments to a future date, or by ordering retroactive UNE rate payments at this time. We base this opinion on the current and well-documented negative market conditions affecting the sector. To leave the issue open, as Pacific suggests, would be even worse than ordering retroactive adjustments because the uncertainty alone would likely undermine the ability of these emerging competitors to gain access to needed investment capital. We cannot in good conscience order a retroactive adjustment, or leave the question open, because of the harm this would cause to the competitive telecommunications sector. This is consistent with our duty under Section 709 of the Public Utilities Code to encourage the development and deployment of new telecommunications technologies, promote economic growth and job creation, and to remove barriers to open and competitive telecommunications markets.

Third, we agree with Joint Applicants that it would be illogical to order retroactive payments to Pacific to cover the increase in the markup when the Commission found earlier this year that certain UNE rates were too high and it ordered downward adjustments to these rates. In D.02-05-042, the Commission found that UNE loop and switching rates should be lowered on an interim basis based on evidence of cost declines. In addition, the Commission has now expanded its review of UNE loop and switching rates to include other UNEs as well based on a preliminary showing that these rates may be above cost. The rates under review form the majority of UNEs purchased by interconnecting carriers. A retroactive adjustment to raise the markup would be contrary to the

Commission's conclusions regarding the price of these UNEs relative to their cost.

Finally, since we have found in today's order that the markup should be increased while at the same time finding that recurring prices should be decreased, these changes largely offset each other and the administrative burden of making these offsetting changes retroactively outweighs the benefit. With the two offsetting changes, any adjustments would probably balance out to a great extent. Indeed, the net effect of the changes might prove to mean payments by Pacific back to competitors. We do not believe that it would be a good use of resources to track the net effect of all of these changes retroactively, especially given the degree to which the changes offset each other.

Therefore, the adjustments to the markup calculation and to UNE recurring prices that we make by this order should apply prospectively from the effective date of this order. We will exercise our discretion and not require any retroactive adjustments.

In addition, we will stay implementation of the increase to the markup pending resolution of the decreases to UNE recurring prices that are discussed above. We would prefer that both of these rate changes go into effect simultaneously. Hence, although both rate changes will apply as of today's date, they will not be implemented until the actual change to the recurring prices has been determined based on additional filings ordered herein.

VI. Comments on Draft Decision

Pursuant to Rule 77.7(f)(9) of the Commission's Rules of Practice and Procedure, the Commission may reduce or waive the period for public comment on draft decisions when the public necessity to act in less than 30 days outweighs the public interest in the normal comment period. The Remand Order vacated

the total direct cost of UNEs in D.99-11-050 and all decisions that rely on it. This has created uncertainty over the UNE prices contained in D.99-11-050, D.02-05-042, and interconnection agreements between Pacific and competitive local carriers. We find that the public necessity in resolving this uncertainty outweighs the public interest in the normal comment period. Therefore, we will reduce the standard time frame for comments on this order so that we can act on this matter at our next Commission meeting and resolve any uncertainty over UNE prices caused by the Remand Order. Parties shall have five days to comment on this order, and one day to file reply comments.

Comments were filed by Joint Applicants, Pacific, and XO. Reply comments were filed by Joint Applicants and Pacific.

Joint Applicants and XO

Joint Applicants claim that the draft decision denies them due process by ignoring the Commission's own rules and unnecessarily abbreviating the comment period on the draft decision. Joint Applicants contend that the draft decision dealing with the Remand Order does not meet the Commission's definition of an emergency because the Court set no deadline for Commission action. Therefore, Joint Applicants request the normal five days for filing reply comments.

Further, Joint Applicants contend the draft decision commits legal error because it sets a shared and common cost markup based on eight year old data rather than undertaking a fresh look at the markup using new information. They request that the Commission modify the draft decision to adopt a markup pursuant to the methodology they presented in comments, or expand the scope of the 2001 / 2002 UNE Reexamination to include updating of the markup. XO

echoes this latter request for an immediate review of the markup using new information.

We disagree that Joint Applicants have been denied due process because of the shortened period for comments on the draft decision. Joint Applicants plead for more time to reply to Pacific's comments on the draft decision, but we are not persuaded by Pacific's comments and we leave the draft decision unchanged. Thus, we find Joint Applicants are not harmed by the shortened reply comment period. Indeed, Joint Applicants prevail in today's order with regard to their argument on the need for revisions to UNE recurring costs. We have made minor modifications to our rationale for why the Remand Order should be dealt with on an expedited basis, but we do not change our conclusion that a shortened comment period is warranted on this matter.

In addition, we disagree with Joint Applicants that it would be legal error to increase the existing markup from 19% to 21% rather than begin an entirely new review of the markup. The Remand Order affirmed the Commission's shared and common cost markup methodology used in D.99-11-050. Given this affirmation by the Court, it is not a violation of TELRIC to keep this methodology in place until a later date. Nothing in the comments persuades us we should undertake an immediate and fresh review of the markup in the UNE Reexamination proceeding.

Along with their reply comments, Joint Applicants filed a motion to strike the attachments to Pacific's September 16 comments on the Draft Decision. Joint Applicants contend that the attachments violate Commission Rule 77.3 because they contain 90 pages of appendices which far exceed the 15 page limit for comments, include documents outside the record or from unrelated phases of OANAD, and raise new information and arguments untested by cross-

examination. According to Joint Applicants, all of these documents and arguments could have been submitted earlier during the comment cycle and prior to the issuance of the Draft Decision. If these attachments are not stricken, Joint Applicants request to supplement their reply comments so as to respond to the new information in Pacific's comments.

We agree that Pacific's attachments to its comments do not meet the requirements of Rule 77.3 because they exceed the page limit, contain new information, and contain information not clearly within the OANAD record. We will grant Joint Applicants' motion to strike in part and strike certain pages of Pacific's attachments, specifically the 1994 Total Operating Expense Report on addendum pages 18 through 53 and the deposition transcripts on pages 79 through 83, because Pacific has not shown that these pages were admitted to the OANAD record. Just as we cannot rely on the Scholl deposition provided by Joint Applicants, we cannot rely on these pages. On the other hand, we have dealt with this Remand Order under a very abbreviated time frame. Therefore, we are inclined to waive aspects of Rule 77.3 on this occasion, and we will not strike all of Pacific's attachments, particularly those that are merely attached for our convenience as copies or excerpts of documents already filed in earlier phases of OANAD. Although we will leave the information attached to Pacific's comments, this does not mean we will give it the same weight as other information, provided on a more timely basis.

Pacific

Pacific maintains that the draft decision erroneously concludes that recurring costs should be adjusted along with any changes to the denominator of the markup calculation. First, Pacific argues that the Remand Order is narrow and pertains only to the denominator of the markup calculation, as set forth in

D.99-11-050. Pacific contends the Commission cannot use the Remand Order to justify modifying recurring costs adopted 21 months earlier in D.98-02-106. We find that Pacific merely reargues its earlier comments in this regard. We have already explained why the Commission cannot consider corrections to the $4.814 billion figure in isolation due to the substantial and direct impacts that corrections to that figure might have on other decisions. Further, it is inaccurate to claim that the $4.814 billion direct cost of UNEs was set in D.99-11-050 when it was actually adopted in D.98-02-106 and its compliance filings, and then merely used again in D.99-11-050 to calculate the markup.

Second, Pacific asserts in its comments that the record from OANAD makes clear that its 1997 recurring cost study does not include non-recurring costs. To support its claims, Pacific presents a 90 page addendum to its comments, purporting to show that non-recurring costs were not included in the recurring cost studies. Pacific claims that any adjustments to recurring costs conflicts with Commission precedents in D.98-12-079, where the Commission considered and rejected the same claim now made by Joint Applicants that the 1997 recurring cost study captured non-recurring costs. According to Pacific, the Draft Decision "fails to identify a single non-recurring cost that was included in the 1997 recurring cost study" and that no such costs exist. (Pacific Bell Comments on Draft Decision, 9/16/02, p. 6.) Pacific asserts that in moving from the 1994 Total Operating Expense report to the 1997 recurring cost study, Pacific removed all non-recurring costs. (*Id.*, p. 5.)

We find Pacific's comments puzzling because as a whole, the comments attempt to demonstrate that there are no non-recurring costs in the $4.814 billion direct cost of UNEs. If so, then that would mean the Commission should not increase the markup by 2%. Pacific asserts repeatedly that non-recurring costs

were removed from its 1997 recurring cost study that led to the recurring costs adopted in D.98-02-106 and its compliance filings. This directly contradicts Pacific's claims that the markup double counts non-recurring costs because the 1997 cost studies included them. Despite what Pacific claims is a clear chain of events, Pacific asks us to believe that in the time span between February 1998 and November 1999, the Commission staff intimately involved with these orders ignored or forgot this clear chain of events and left non-recurring costs in the $4.814 billion used in the markup calculation. If it were so obvious that non-recurring costs were removed from the 1997 cost studies, as Pacific asserts in its comments, why wouldn't the Commission have been able to use successfully this same line of reasoning to defend its markup calculation in Federal District Court?

Indeed, the Commission did try to use this same line of reasoning in Federal District Court and did not prevail. The Commission asserted that the original 19% markup was correct because it had stated in D.99-11-050 that D.98-02-106 only dealt with recurring costs and D.98-12-079 only dealt with non-recurring costs.[23] At the time, the Commission satisfied itself that its decisions adequately separated recurring and non-recurring costs and there was no double counting. This is the same argument that Pacific is putting forth now because it wants us to now rely on the findings and conclusions from D.98-12-079 and D.98-02-106 that we tried to rely on in defending the markup calculation. Yet the Court rejected the Commission's reasoning as circular because it failed in the face of simple arithmetic. (Remand Order, p. 37.) Similarly, we find that Pacific's

[23] See D.99-11-050, p. 71, n. 71.

assertions are not supported by any mathematical calculations. Just as the Court wanted a mathematical explanation of how non-recurring costs were removed from the $4.814 billion figure, we would need a mathematical explanation today to be satisfied that the $4.814 billion used to set recurring costs did not include $537.8 million in non-recurring costs. Pacific's comments have not provided this.[24]

Pacific argues that it is unreasonable to assume the parties and Commission staff missed over half a billion dollars in non-recurring costs when adopting recurring costs. Yet, the Court was persuaded that an oversight of over half a billion dollars had indeed occurred in the calculation of the markup. Because we now rely on Pacific's 1997 cost studies as documentation of this oversight, we conclude that a corresponding adjustment needs to be made in the recurring cost studies.

We agree with Joint Applicants that statements by Pacific's witness Scott Pearsons in the non-recurring cost phase of OANAD do not resolve this controversy either. (*See* Pacific Comments on Draft Decision, 9/16/02, Addendum p.14.) In fact, the Pearsons declaration from that phase of OANAD merely contradicts once again Pacific's current stance that the markup needs correcting. We are reluctant to rely solely on the Pearsons declaration absent a

[24] In its reply comments on the draft decision, Pacific inserts a new argument that "multiplication of [the recurring costs established in D.98-02-106] by volumes reflected in Pacific's cost filings – which are part of the record in OANAD – yields a total of approximately $3.6 billion." (Pacific Reply Comments to Draft Decision, 9/17/02, p. 4, n. 28.) Thus, Pacific claims this is further verification that the recurring costs do not include non-recurring costs. Not only is this new argument raised inappropriately in reply comments on a draft order, but we have no means to validate this claim and we have no idea what "volumes" Pacific is referring to.

mathematical showing of the removal of the non-recurring costs at issue from the $4.814 used to set recurring costs.

Pacific claims that the Commission has no evidence that non-recurring costs were included in the 1997 recurring cost study. But in fact, this order relies on the same evidence that Pacific used to convince the Court that the markup calculation was wrong. Pacific asks us to accept that non-recurring costs were not included in the 1997 recurring cost study, but it uses the same 1997 cost study to convince the Court and the Commission that non-recurring costs were included in the $4.814 total direct cost of UNEs. We cannot reconcile these two positions.

Pacific is merely expanding on its unsupported "subsequent cost study" argument that it made earlier. We cannot verify Pacific's assertions regarding the removal of non-recurring costs because Pacific provides no citation or reference showing how the calculations were performed. The Court agreed with Pacific that non-recurring costs were included in its 1997 cost study. By the same logic and based on the same evidence that the Court used to make this finding, we find that non-recurring costs are part of the $4.814 billion direct cost of UNEs used to set recurring costs.

Findings of Fact

1. The Commission adopted a shared and common cost markup of 19% in D.99-11-050.

2. In its Remand Order, the U.S. District Court found that the Commission had double-counted non-recurring costs in the denominator of the shared and common cost markup.

3. The Remand Order vacated and remanded to the Commission the $4.814 billion total direct UNE costs used in the denominator of the markup calculation, and any decision that relied on the $4.814 billion.

4. Pacific included $583 million in non-recurring costs in its original $4.83 billion estimate of total direct UNE costs.

5. The $583 million estimate was decreased to $537.8 million based on a labor rate adjustment.

6. Pacific's original $4.83 billion estimate of total direct UNE costs was revised to $4.814 billion through compliance filings with the Commission, and the revisions did not remove either $583 or $537.8 million in non-recurring costs.

7. The deposition testimony of Pacific's witness Scholl, in which he testified regarding PBON 001684 through PBON 001746 and stated that non-recurring costs were not included in the recurring cost study, was never introduced into the record of the OANAD proceeding.

8. Pacific's 1997 cost filing indicates PBON 001684 through PBON 001746 as the source for $4.139 billion in 1994 Total Regulated Operating Expenses.

9. 1994 Total Regulated Operating Expenses are comprised of recurring costs and $537.8 million in non-recurring costs.

10. 1994 Total Regulated Operating Expenses of $4.139 billion are a component of the $4.814 billion total direct UNE costs.

11. The $4.814 billion total direct UNE cost adopted in D.98-02-106 and related compliance filings was used to calculate the 19% shared and common cost markup and recurring charges in D.99-11-050.

12. In D.98-12-079, the Commission adopted $375 million in non-recurring costs, which was used to set Pacific's non-recurring charges.

13. Addendum pages 18 through 53 and 79 through 83 of Pacific's comments on the Draft Decision were not included in the record of OANAD.

Conclusions of Law

1. The Commission should subtract $537.8 million in non-recurring costs from the $4.814 billion total direct cost of UNEs in the denominator of the markup calculation.

2. Pacific's shared and common cost markup, originally calculated in D.99-11-050 (Conclusion of Law 19), should now be calculated by dividing $996 million in shared and common costs by $4.651 billion ($4.814 billion in total direct UNE costs minus $537.8 million in non-recurring costs plus $375 million in non-recurring costs (adopted in D.98-12-079). The result of this calculation, 21.4%, should be rounded to the nearest whole percentage point, which results in a markup of 21%.

3. Pacific's shared and common cost markup should be increased from 19% to 21%.

4. We should not rely on Scholl's deposition testimony because it was not introduced in the original OANAD record.

5. Because $537.8 million in non-recurring charges are included in $4.139 billion in 1994 Total Regulated Operating Expenses, and this $4.139 billion was used to calculate $4.814 billion in total direct UNE costs, $537.8 million in non-recurring costs are included in $4.814 billion total direct UNE costs.

6. In response to the Remand Order, the Commission should remedy any decision that relies on the $4.814 billion direct UNE cost, including D.98-02-106 and its compliance filings that used this figure to calculate UNE recurring costs.

7. Pacific is double recovering non-recurring costs because there are $537.8 million in non-recurring costs contained in the to $4.814 billion total direct cost of

UNEs, and Pacific is also charging non-recurring prices based on non-recurring costs adopted in D.98-12-079.

8. The $537.8 million in non-recurring costs included in the $4.139 billion 1994 Total Regulated Operating Expenses (which is a component of the $4.814 billion total direct UNE costs), should be removed from Pacific's recurring UNE costs.

9. The Commission should calculate the amount that the expense component of recurring costs was overstated by dividing the $537.8 million in non-recurring costs by the $4.139 billion in 1994 Total Regulated Operating Expenses, which yields 12.9%, or 13%.

10. Pacific should reduce the expense portion of its recurring costs for each UNE by 13% to remove non-recurring costs included in the $4.814 billion total direct cost of UNEs.

11. The Commission has discretion to determine when and if to order retroactive rate adjustments in response to the Remand Order.

12. Bankrupt telecommunications carriers might have difficulty paying retroactive adjustments to UNE rates.

13. Retroactive UNE rate adjustments would be inconsistent with the Commission's duties under Pub. Util. Code § 709 because retroactive payments would be likely to cause regulatory and financial uncertainty and restrict access to capital.

14. Retroactive UNE rate adjustments would not be a good use of resources since the net adjustments are likely to largely offset each other.

15. The Commission should not make retroactive adjustments to rates in response to the Remand Order due to telecommunication carrier bankruptcies, the effect of uncertainty caused by retroactive payments and its effect on the

struggling telecommunications sector, the recent findings regarding UNE rates in D.02-05-042 and the UNE Reexamination proceeding, and the fact that the net rate changes probably offset each other to a great degree.

16. The changes to the shared and common cost markup and recurring costs adopted in this order should be made on a prospective basis and be effective on the same date as this order.

17. The actual implementation of the increase to the markup should be stayed pending final determination by the Commission, through additional filings ordered herein, of changes to recurring costs based on the 13% adjustment to the expense portion of recurring costs.

18. The period for public review of the draft decision should be reduced because the public necessity in resolving uncertainty over UNE prices created by the Remand Order outweighs the public interest in the 30-day comment period.

19. Addendum pages 18 through 53 and 79 through 83 of Pacific's comments on the Draft Decision should be stricken.

O R D E R

IT IS ORDERED that:

1. The shared and common cost markup that was originally adopted in Decision (D.) 99-11-050, and which is a component of Pacific Bell Telephone Company's (Pacific's) unbundled network element (UNE) prices, shall be increased from 19% to 21%.

2. The expense portion of Pacific's UNE costs adopted in D.98-02-106 shall be modified to incorporate a 13% reduction as set forth in this order.

3. Within 30 days of this order or as otherwise directed by the Administrative Law Judge (ALJ), Pacific shall submit a filing in this proceeding calculating a 13% reduction in the expense portion of each of the recurring costs adopted in

D.98-02-106 and calculating the net impact on all of its UNE prices of the markup and recurring cost changes ordered herein. Pacific's filing should be fully supported with workpapers and appropriate documentation, and these workpapers and documentation should be made available to parties, subject to applicable nondisclosure agreements, upon request. Interested parties may file comments on Pacific's filing 20 days thereafter, unless a revised schedule is set by the ALJ.

4. The changes adopted by this order to Pacific's shared and common cost markup and to the expense portion of its UNE recurring costs shall be effective on the date this order is effective, but implementation of these rate changes shall be stayed pending final determination by the Commission of the actual rate changes.

5. In order to make the UNE price changes effective as of today's order, Pacific shall track UNEs purchased by interconnecting carriers from the date of this order until the Commission determines the net effect of the UNE price changes resulting from this order.

6. Pacific shall make all billing adjustments necessary to ensure that this effective date is accurately reflected in bills applicable to the UNE prices modified by this order.

7. The motion of AT&T Communications of California, Inc. and WorldCom, Inc. to strike Pacific's comments on the Draft Decision is granted in part, and denied in all other respects.

This order is effective today.

Dated September 19, 2002, at San Francisco, California.

LORETTA M. LYNCH
President

CARL W. WOOD
GEOFFREY F. BROWN
Commissioners

We will file partial dissents.

/s/ HENRY M. DUQUE
Commissioner

/s/ MICHAEL R. PEEVEY
Commissioner

Appendix A

Pacific's Calculation of $4.814 Billion Direct Cost of UNEs[1]

Step 1:
Calculation of Total Service Long Run Incremental Cost (TSLRIC)

Total Capital Costs	$3,077[2]
Operating Expenses	3,900[3]
	6,977
Less Shared and Common	2,206
Total Estimated TSLRIC	**$4,770**

(Source: Pacific Bell Comments, 8/28/02, Addendum p. 8, "1997 Cost Study, Tab D-5, pg. 8.")

Step 2:
Transformation of TSLRIC to TELRIC

Total Estimated TSLRIC (From Step 1 above)[4]	$4,770.
Add spare capacity	383.2

[1] These figures are all taken directly from Pacific's 1997 Cost Filing, filed January 13, 1997 in the OANAD proceeding. All of the figures in this appendix were originally stamped by Pacific as proprietary and confidential and were filed under seal. Nonetheless, Pacific filed these figures in its 8/28/02 public comments in response to the August 15th ALJ ruling on the Remand Order without requesting that they be filed under seal.

[2] All dollars in millions unless otherwise noted.

[3] This figure is derived starting with $4.139 billion in 1994 Total Regulated Operating Expenses, to which certain additions and subtractions are made. Pacific agrees that $4.139 billion contains recurring and non-recurring costs. *(See* Pacific Bell Comments, 8/28/02, Addendum p. 15.)

[4] There is no explanation in Tab D-5 for the difference between 4,770 on pg. 8 and 4770.5 used on pg. 2.

Add COPT Coin/Public		102.7
Other additions	100.2	
Other removals	525.9[5]	
Total Estimated TELRIC	**$4,830.7**	

(Source: Pacific Bell Comments, 8/28/02, Addendum p. 2, "1997 Cost Study, Tab D-5, pg. 2.")

Step 3:
Adjustments to Pacific's $4.830 billion Total Direct Cost of UNEs[6]

Total Estimated TELRIC	$4,830.7
Plus Loop Repair trending	29.9
Minus Loop repair trending	42.5
Minus Shared Family Fiber Ring Spare	59.9
Adjusted TELRIC	**$4,758.2**
Plus PIM Reassignment	55.5
Adjusted TELRIC	$4,813.7

(Source: Pacific Bell Comments, 8/28/02, Addendum p. 24, "Compliance Filing for Advice Letter 19306, March 6, 1998," and Addendum p. 28, "Compliance Filing for Advice Letter 19306B, October 29, 1998.")

(END OF APPENDIX A)

[5] This figure is a summation of removals for service specific advertising, 9-12 Kft adjustment, loop repair trending, labor rate adjustment, rearrangement adjustment, and retail billing inquiries.

[6] Pacific explains that none of the adjustments shown in Step 3 involve removal of the original $583 million estimate of non-recurring costs. (Pacific Comments, 8/28/02, p. 5, n. 17.)

Commissioner Henry M. Duque dissenting in part:

The analysis concerning the proposed 13% adjustment to Pacific's recurring costs is as unconvincing as the case made by both sides of the argument in this limited and truncated process. The question regarding whether or not non-recurring costs have are present in the recurring costs has not been adequately addressed in this order. I will support the order in so far as the adjustments relate to what the court found for non-recurring costs, but I will dissent in part with respect to recurring costs adjustments. I believe a legal error may have been committed in this order, which I hope the Commission will correct before the orders goes into effect.

For the above reason I will respectfully dissent in part.

/s/ HENRY M. DUQUE

Henry M. Duque

Commissioner

September 19, 2002
San Francisco, California

A.01-02-024 et al.
D.02-09-049

Commissioner Peevey, concurring opinion and partial dissent:

I concur with part of today's decision. The U.S. District Court for the Northern District of California vacated and remanded back to us the issue of the UNE shared and common allocator because the court found that this Commission had double-counted non-recurring costs. The decision does a thorough job of remedying the double-counting by changing the shared and common cost allocator from 19% to 21%. Many parties filed technical workpapers that had to be reviewed and analyzed. The decision performs the appropriate analysis and makes the proper adjustment to the shared and common allocator. I wished the decision had stopped here; if it had, I would fully support it.

I dissent, in part, because the decision goes on to order a 13% decrease to be applied to expenses. This was not the intent of the court order. Page 38 of the court's order states "The [Commission's] determination of Pacific's direct cost of providing UNEs (the denominator of the common cost markup), and any decision which relies on this determination, must be vacated and remanded, *so that the double-counting can be remedied*." (emphasis added) From the plain words of the court order, the intent clearly is to correct the double-counting. Therefore, any action beyond the correction of double-counting was not required, is unnecessary, unwarranted and gratuitous.

Hypothetically, if the root of the double-counting leads to other errors, we can and should correct them. However, the court did not order such an undertaking, nor should such a task be rushed. The proper procedure (should there be a belief that this hypothetical may exist) would be simply to correct the double-counting and then continue the proceeding to investigate if there are other errors.

/s/ MICHAEL R. PEEVEY
MICHAEL R. PEEVEY
Commissioner

San Francisco, California

September 19, 2002